Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:VWV:RCH:TL-N-2288-99
CMDRees

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to: Chief, Examination Division, Virginia-West Virginia District
Chief, Coordinated Examination Branch
Attn.: Jack Ferguson, Manager, Group 1116

from: CHERYL M.D. REES
Attorney

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subject: [redacted] **and Consolidated Subsidiaries Application of Claim of Right Doctrine To Environmental Remediation Expenses Under I.R.C. § 1341**

DISCLOSURE STATEMENT

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This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether the taxpayer may treat environmental clean-up costs accrued and otherwise deductible in the taxable years [redacted] through [redacted] as "item[s] . . . included in gross income for prior taxable years" that the taxpayer has "restored," for purposes of

computing its tax under I.R.C. § 1341.

2. Whether agreeing to settlement of the amount of the deductions to which [redacted] would be entitled in its [redacted] through [redacted] or later taxable years, without regard to the provisions of I.R.C. § 1341, would prejudice the Service's litigating position in regard to the section 1341 issue.

CONCLUSIONS

1. The alternate tax computations under I.R.C. § 1341 are not available to the taxpayer since payments for environmental clean-up do not constitute restored items of gross income held under a claim of right.

2. An agreement between [redacted] and the Service as to the amounts deductible by them in later years would not prejudice the Government's litigating position in regard to the I.R.C. § 1341 issue. Care should be taken, however, not to agree to a characterization of the deductions unless the Service has determined the proper characterization.

FACTS

The facts recited herein are taken from the documents you forwarded. We have indicated those instances where we are uncertain that claims made by the taxpayers have been verified. If the facts are found to be different than those recited, it may be that the changes would cause us to alter our advice.

[redacted] and Consolidated Subsidiaries [hereinafter referred to as [redacted]] primarily deal in [redacted] production and manufacturing, with a strong emphasis on [redacted] products. The general public knows [redacted] best for their line of [redacted] products, but they also have businesses involving such activities as packaging and construction.

[redacted] [redacted] through [redacted] corporate tax returns are currently open. Some of them are under examination and others are scheduled for examination in a later cycle. With regard to [redacted] [redacted] through [redacted] tax returns, they have filed informal claims for refund asserting that they are entitled to use the alternate tax computations under I.R.C. § 1341 as a result of monies paid or accrued in those years for environmental remediation. They included the alternative computations on their return as filed for their [redacted] taxable year. They have not yet filed their [redacted] income tax return. We are not yet certain how they classified the alleged costs of environmental remediation on

their [redacted] through [redacted] returns.

In addition to the question of whether section 1341 applies, the question of the amount of the deduction to which [redacted] is entitled is at issue in the pending examinations.[1] One element of that issue is the proper timing of the deduction of the alleged costs as among the open years or years that have not yet occurred. The examining agents and the taxpayers are currently evaluating a settlement proposal as to the proper timing of deductions and amounts thereof in the years [redacted].

According to [redacted] informal claims, from [redacted] through [redacted][2] they included waste disposal costs and similar costs incurred in connection with their manufacturing operations in their computation of cost of goods sold.[3] They argue that, pursuant to Treasury Regulation § 1.61-3(a) and In re Lilly, 76 F.3d 568(4th Cir. 1996), because the waste disposal costs, costs of goods sold, were understated in the early years, they included items in gross income which they later had to pay back when they paid or incurred expenses for environmental remediation from [redacted] through [redacted]. Computation of their tax under the alternate method provided for in I.R.C. § 1341 would reduce their tax liabilities for [redacted] through [redacted] by a total of $[redacted]. According to the taxpayer, [redacted] typically accrues environmental remediation costs in reserve accounts for book purposes in order to track the estimated costs to clean up the various contaminated sites. Consequently, [redacted] posts

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[1] Once determined, the majority of amounts would be allowable as deductions or costs of goods sold in current years if section 1341 does not apply or would comprise part of the computation of tax under I.R.C. § 1341(a)(5) if that section were to apply. It is possible that some of the costs might more properly be capitalized.

[2] [redacted] did not make computations for post-[redacted] taxable years since changes in corporate tax rates essentially eliminated the need to apply for the mitigation relief provided by I.R.C. § 1341.

[3] It is our understanding that the examining agents have not yet determined whether these costs were or should have properly been included as costs of goods sold in [redacted] taxable years. We believe that their argument will fail whether they were properly included as cost of goods sold or as "other deductions." However, if the costs should have been deducted as "other costs," the foundation of [redacted]'s argument crumbles.

Schedule M-1 adjustments on the tax return each year to ensure that the deduction is taken in the year that the payment is actually made in accordance with the requirements of the economic performance regulations under I.R.C. § 461.

[redacted] argues that the contamination it is now cleaning up was connected to prior manufacturing operations and waste disposal practices. It advances the proposition that, from [redacted] through [redacted], they followed industry standards in disposing of waste and that their methods were consistent with Federal regulations. It was not until later years that Federal regulations were changed in response to increased awareness of environmental hazards.

In computing their claimed benefits under I.R.C. § 1341, [redacted] has looked at [redacted] sites that are, or were, the target of environmental remediation during their [redacted] through [redacted] taxable years. Needless to say, the computations employed by [redacted] in arriving at their claims are quite complex. Although we have seen their summary explanation of the methodology, we have not reviewed their computations.

[redacted] is currently involved in litigation against its insurance carrier in an attempt to recover the costs of environmental remediation.

ANALYSIS

ISSUE 1

I.R.C. § 1341 was enacted by Congress in 1954 to mitigate the sometimes harsh effect of the application of the inclusion of income as a result of the "claim of right" doctrine. That doctrine was first applied by the United States Supreme Court in North American Oil v. Burnet, 286 U.S. 417 (1932). In North American Oil, the Supreme Court held that income received under a claim of right, with no restriction as to its use, is taxable in the year of its receipt even where the taxpayer might claim that it was not entitled to retain the income and might be held liable to restore it in a later year. Id. at 424; see, Maier Brewing Company, et al. v. Commissioner, T.C. Memo. 1987-385.

The harshness of this doctrine was exemplified in United States v. Lewis, 340 U.S. 590 (1951). In Lewis, the taxpayer had included on his 1944 return income he had received in that year as a bonus from his employer. It was later determined that the bonus had been improperly computed. In 1946, therefore, he had to return $11,000.00 of his bonus to his employer. The Supreme

Court held that his 1944 return could not be re-opened and the gross income reduced. United States v. Lewis, 340 U.S. 590, 591-92 (1951). After this case, adjustments could only be made, if a deduction was allowable, in the year of repayment of the sum once included in income. Maier Brewing Company, et al. v. Commissioner, T.C. Memo. 1987-385. It was in response to Lewis that Congress enacted I.R.C. § 1341. Because of variations in tax rates and variations in gross income, a deduction in a later year might place a taxpayer in a far worse situation than if he had not originally included the restored item in income. H. Rept. No. 1337, 83d Cong., 2d Sess. (1954).

The legislative history of I.R.C. § 1341 indicates that it was enacted to adequately compensate a taxpayer for the tax he paid for a prior year when he subsequently has been obliged to restore amounts he had included in gross income in the prior year because it appeared that he had an unrestricted right to such amount. Senate Report No. 1622, 83rd Cong., at pages 118 and 451; H. Rept. No. 1337, 83d Cong., 2d Sess., A294 (1954). Thus, the purpose of I.R.C. § 1341 was to place such a taxpayer at least in no worse a tax position than he would have been had he never received the income originally. Rev. Rul. 72-551, 1972-2 C.B. 508.

Under Section 1341, there are two alternative approaches to computing the tax for the year of repayment. The tax due is the lesser of the amounts produced by the two approaches:

> Under the first approach, the taxpayer merely calculates its tax liability after having deducted the repayment in arriving at taxable income. I.R.C. § 1341(a)(4).
>
> Under the second approach, tax is computed for the year of repayment without deduction, but with a reduction in tax liability equal to the reduction in tax that would have occurred in the year of receipt had the amount of the repayment been excluded from income. I.R.C. § 1341(a)(5).

In order for [redacted] to succeed in their claims that they are entitled to reduce their tax liability under the provisions of I.R.C. § 1341, they must prove that each of the following six conditions have been met:

1. the items at issue were items included in

gross income in a previous taxable year, § 1341(a)(1);

2. the inclusion occurred because the taxpayers appeared to have an unrestricted right to the items, § 1341(a)(1);

3. in a later tax year, the taxpayers are entitled to a deduction on account of the repayment, § 1341(a)(2);

4. the deductions are allowable because it was established after the close of the year of inclusion that the taxpayers did not have an unrestricted right to the items, § 1341(a)(2);

5. the amount of the deductions exceed $3,000.00, §1341(a)(3); and,

6. the provisions of I.R.C. § 1341(a) are not specifically made inapplicable because the items which were included in gross income were included by reason of the sale or other disposition of stock in trade of the taxpayers (or other property of a kind which would properly have been included in the inventory of the taxpayers if on hand at the close of the prior taxable year) or property held by the taxpayers primarily for sale to customers in the ordinary course of their trade or business. I.R.C. § 1341(b)(2).

The taxpayers claim that they satisfy each of these requirements and are, therefore, eligible to reduce their tax liabilities. We will discuss each of the six conditions individually.

1. The Items At Issue Were Items Included In Gross Income In A Previous Taxable Year

With respect to the first statutory requirement, [redacted] claims that they included items in gross income in prior taxable years by understating waste disposal and similar type costs which should have been included in each prior year's cost of goods sold. In so doing, they contort the plain meaning of the statute and its "claim of right" underpinnings and seek to obfuscate the concept of the word "item." Section 1341 is titled, "Computation of tax where taxpayer restores substantial amount held under

claim of right." The claim of right doctrine has always included sums that are taken into income because it appeared from all the facts and circumstances at the time of its inclusion in income that the taxpayer had an unrestricted right to the income. See, e.g., North American Oil v. Burnet, 286 U.S. 417 (1932); United States v. Lewis, 340 U.S. 590 (1951); Cal-Farm Insurance Co. v. United States, 647 F. Supp. 1083 (ED Cal. 1986). There are no cases under the claim of right doctrine or I.R.C. § 1341 in which the income at issue was "included" in income as a result of the forbearance of the taxpayer to take increased cost of goods sold or deductions, or, in other words, as a result of a taxpayer's missing of an opportunity to take a deduction. See, e.g., Cal-Farm Insurance Co. v. United States, 647 F. Supp. 1083, 1091-92 (ED Cal. 1986); First National Bank of Elkhart County v. United States, 330 F. Supp. 975, 977 (N.D. Ind. 1971).

In support of their assertion, [redacted] cites Treas. Reg. §1.61-3(a) and In Re Lilly, 76 F.3d 568 (4th Cir. 1996). The taxpayer attempts to fit the remediation expenses into the classification of a restored item of gross income by using the definition of gross income found in Treas. Reg. 1.61-3(a) which states that, for manufacturers, "'gross income' means the total sales, less the cost of goods sold." While cost of sales clearly constitutes a component of the gross income computation, the taxpayer over reads the Treasury Regulation by suggesting that the remediation costs were items previously *included* in gross income under a claim of right.

The statute is clear that section 1341 relief is restricted to items of income previously *received* and reported by a taxpayer who must repay those *same* items in a subsequent year. See, Estate of Smith, et al. v. Commissioner, 110 T.C. 12 (1998); Cal-Farm Insurance Co. v. United States, 647 F. Supp. 1083 (ED Cal. 1986). Revenue Ruling 72-28 further supports a position that I.R.C. § 1341 applies only to the gross receipts component of gross income and not the cost of sales component. The taxpayer in Rev Rul. 72-28 was a public utility company that was subjected to a contingent rate increase on its gas purchases in 1969. The taxpayer passed these rate increases on to its customers dollar for dollar by collecting a corresponding amount of the increase in the purchased gas expense from the customer. The taxpayer properly reported the additional amount collected as gross income in 1969. It, of course, deducted the additional

cost of gas as a cost of goods sold in 1969 as well.[4]

During 1970, the taxpayer received refunds from its suppliers of some of the cost increases paid to them in 1969. The taxpayer included these supplier refunds in its gross income for 1970. Also in 1970, the taxpayer made corresponding equivalent refunds to its customers. The taxpayer sought I.R.C. § 1341 treatment for the amounts repaid to its customers in 1970 and deductible for that year. The issue in Rev. Rul. 72-28 was whether I.R.C. § 1341 applied, even though for 1969 the taxpayer had increased its cost of sales by amounts equal to the increase in gross receipts from its customers, causing no net effect on gross income.

The Service ruled that I.R.C. § 1341 applied to refunds made by the public utility company to its customers, for which it could claim a deduction in the subsequent year. The Service held that the fact that the taxpayer had increased cost of sales in prior years "has no relevancy in determining the application of Sec. 1341." Likewise, [redacted] treatment of cost of sales does not implicate I.R.C. § 1341 treatment.

Chief Counsel reviewed the conclusion in Rev. Rul. 78-28 which created an apparent windfall for taxpayers. In GCM 35403, Counsel addressed the Treas. Reg. § 1.61-3(a) issue by stating that the term "included in gross income" must mean "included in the computation of gross income." In GCM 35403, Chief Counsel emphasized that I.R.C. § 1341(a)(1) does not refer merely to "gross income" but uses the phrase "an *item* of gross income." The importance of this distinction is reinforced by I.R.C. § 1341(a)(2) which states that a deduction is allowed in a later year because it is established that the taxpayer did not have an unrestricted right to the ***item***. It follows that it must be possible to identify the various component items of gross income in order for I.R.C. § 1341 to have any vitality. The GCM states that use of the Treas. Reg. § 1.61-3 definition would eliminate the concept of an ***item***. Accordingly, we read GCM 35403 to mean that the cost of goods sold component must be ignored for purposes of I.R.C. § 1341.

Because the Virginia-West Virginia District lies in the Fourth Circuit, we will take a closer look at In re Lilly, 76

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[4] In essence, the taxpayer's gross receipts and cost of sales increased by the same amount for 1969, leaving gross income as defined by Treas. Reg. § 1.61-3(a) unaffected.

F.3d 568 (4th Cir. 1996), cited by [redacted] in support of their claims, than may be necessary in regard to taxpayers in other parts of the country. In re Lilly had nothing whatsoever to do with the claim of right doctrine or I.R.C. § 1341. [redacted] cites the case simply because the Fourth Circuit Court of Appeals defined an item of "gross income" to their liking. The definition, however, was in a completely unrelated context. The issue before the court in In re Lilly was whether the debtor in a bankruptcy proceeding was an innocent spouse under I.R.C. § 6013(e).

Prior to its amendment in 1984, § 6013(e) provided innocent spouse relief only in the case of an omission "from gross income of an amount properly includable therein. . . ." A special rule required that the amount omitted from gross income for purposes of § 6013(e) must be determined in the manner provided by section 6501(e)(1)(A). I.R.C. § 6013(e)(2)(B)(prior to its deletion in 1984). Under section 6501(e)(1)(A), in the case of a trade or business, the term "gross income" for purposes of determining whether the 6-year statute of limitations for assessment or collection applied, was defined as the "total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services. . . ." I.R.C. § 6501(e)(1)(A)(i).

Congress deleted the special definition of gross income when it amended I.R.C. § 6013(e) in 1984. It also allowed for one to receive innocent spouse treatment in certain circumstances if a return claimed a deduction, credit, or basis by a spouse in an amount for which there was no basis in fact or law. The level of proof necessary for a hopeful innocent spouse to succeed in the case of an omission from gross income was less than that necessary in reference to overstated deductions, credits or basis.

In In re Lilly, the taxpayer/debtor would succeed in her claim that she was an innocent spouse if the inflation of cost of goods sold by her husband on their joint return was defined as and "item of gross income" and she would fail if the inflation of cost of goods sold was determined to be a deduction, credit or basis. The Court only had two choices. It had to find that the inflation of cost of goods sold was either an "item of gross income" or it was a "deduction, credit or basis." Given those two choices, the Court determined that, **for purposes of the innocent spouse provisions**, an increase in the cost of goods sold

was "an item of gross income" rather than a deduction, credit or basis. In so deciding, the court relied on two Tax Court cases that had come to the same conclusion.[5] The fact that this is so in the context of the innocent spouse provisions, however, has not convinced the Tax Court or any other court that the same is true for the phrase, "an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item," that appears in I.R.C. § 1341.

The legislative history regarding I.R.C. § 1341(b)(2) also weighs against [redacted] interpretation. I.R.C. § 1341(b)(2), discussed more fully below, provides that the mitigating effect of section 1341 does not apply to any deduction allowable with respect to an item that was included in gross income due to the sale or other disposition of a taxpayer's stock in trade or other property in the nature of inventory. I.R.C. § 1341(b)(2). At the time of the passage of the provision in 1954, the Senate Committee Report explained that the section was specifically made inapplicable to sales of inventory and stock in trade because an accrual-basis taxpayer could instead estimate sales returns and guarantees in accordance with section 462. Senate Report No. 1622, 83rd Cong., 2nd Session. In excluding a remedy for items of gross income attributable to sales of inventory because I.R.C. § 461 provided an adequate remedy, Congress gave a clear indication of the type of harm it sought to redress. Understated cost of goods sold were simply not within its contemplation. Had this been so, section 461 would not have provided an adequate remedy.

Even if [redacted] theory regarding cost of goods sold were correct, the computation under I.R.C. § 1341(a)(5) would seemingly provide no benefit. Under I.R.C. § 1341(a)(5), the tax is computed for the earlier year as if the amount of repayment had been excluded from income. The amount of the costs of remediation **were** excluded from the computation of gross income in each of the earlier years. A reduction of tax would occur only if the costs were now <u>included</u> <u>in</u> the computation. Such an interpretation would result in I.R.C. § 1341 providing relief for

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[5] There has been one subsequent Tax Court decision that reached the same holding. In view of the fact that, in 1984, Congress deleted from the innocent spouse provisions the definition that "gross income" referred to income prior to its reduction by cost of goods sold, the courts' findings are quite predictable.

the inability of a taxpayer to take a deduction in an earlier year because it could not fulfill the all events requirement of I.R.C. § 461 in the earlier year. There is no basis to believe that Congress intended such relief. Furthermore, the statutory language does not support it.

2. The Inclusion Occurred Because The Taxpayer Appeared To Have An Unrestricted Right To The Item.

In order to succeed in proving this element, [redacted] would have to contort the definition of "inclusion" and would have to argue that they had an "unrestricted right to the item" included. In fact, it had an absolute right to each item included in income and, presumably an absolute right to the cost of goods sold claimed. To follow through with their argument that it was their omission of increased costs of goods sold, it seems they would have to argue that they had an unrestricted right to miss the opportunity to claim a larger costs of goods sold in each year. [redacted] has not attempted this gymnastic feat in their claims. Instead, they argue that, at the end of each year from [redacted] through [redacted], it "appeared" that they had accrued and accounted for all waste disposal costs and it, therefore, appeared that they had an unrestricted right to use their reported gross income from [redacted] through [redacted].

Treasury Regulation § 1.1341-1(a)(2) provides that "income included under a claim of right' means an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such an item . . . ." Section 1341 (or its predecessor, the "claim of right" doctrine) does not apply where a taxpayer included income under an absolute right. Rev. Rul. 58-226, 1958-1 C.B. 318; see, e.g., Blanton v. Commissioner, 46 T.C. 527 (1996), aff'd. 379 F.2d 558 (5th Cir. 1967); Usher v. Commissioner, T.C. Memo 1980 - 180.

In Blanton v. Commissioner, 46 T.C. 527 (1996), aff'd. 379 F.2d 558 (5th Cir. 1967), the taxpayer received director's fees from a corporation and reported them in income. In a later year, he entered into an agreement to return the director's fees if the Service subsequently determined that the fees were excessive for Federal income tax purposes. Thereafter, the Service examined the corporation's return for the year in which the taxpayer had included the director's fees as income and determined that the fees had been excessive. The taxpayer sought to use the alternative tax computations provided under I.R.C. § 1341(a)(5) in the year in which he repaid the amount of the fees found to be

excessive.

The Tax Court interpreted I.R.C. § 1341 to apply only where the refund or repayment event arises "out of the circumstances, terms, and conditions of the original payment of such item to the taxpayer and not out of circumstances, terms, and conditions imposed upon such payment by reason of some subsequent agreement between payor and payee." Id. at 530. The Court then determined that, since the repayment agreement was not in existence when the taxpayer received the income at issue, the obligation to repay the director's fees did not arise out of the "circumstances, terms, and conditions" of the original payment of the director's fees. Id. The Court denied the taxpayer relief under I.R.C. § 1341. The taxpayer in Blanton had an absolute right to the income he reported in the year in which it was reported.

On their returns from [redacted] through [redacted], [redacted] reported income received from the sale of its various products. They had an absolute right to that income in the years in which it was reported. If there has ever been an event that caused them to repay some of the sales proceeds, they have not made a claim as a result of these repayments. The amounts [redacted] received from the sale of their products bore no relationship to the remediation costs they ultimately incurred. Because [redacted] had an absolute right to the income they reported, they cannot satisfy the second requirement.

3. and 4. In A Later Tax Year, The Taxpayer Is Entitled To A Deduction On Account Of The Restoration Or Repayment Of The Item Previously Included In Income And The Deduction Is Allowable Because It Was Established After The Year Of Inclusion That The Taxpayer Did Not Have An Unrestricted Right To The Item.[6]

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[6] One necessary element of proof is that a taxpayer substantiate that it is entitled to a deduction in the later year(s) under some section of the I.R.C. other than § 1341. Although the timing and amount of the deductions to which [redacted] are entitled remains an issue, it is clear that they are entitled to some amount in some year(s) on account of their costs of environmental remediation. One flaw in their overall argument may be that they must argue that the costs of waste disposal in early years were taken as, and allowable as, costs of goods sold but that the costs of remediation in later years were taken as, and allowable as, deductions. This chips away a bit at their argument that there is a direct relationship between the two and that remediation costs, taken as deductions currently, would have

The U. S. Tax Court has held that for I.R.C. § 1341 to apply, the deductible, restored items must be directly connected to the items that were previously included in gross income. Uhlenbrock v. Commissioner, 67 T.C. 818, 823 (1977). In interpreting I.R.C. § 1341(a)(1) and 1341(a)(2), the Court requires that the obligation to repay an item of income arises out of the specific circumstances, terms, and conditions of the same transaction in which the amount was originally required to be included in income. See, e.g., Pahl v. Commissioner, 67 T.C. 286 (1976); Blanton v. Commissioner, 46 T.C. 527, 530 (1996), aff'd. 379 F. 2d 558 (5th Cir. 1967).

In its recent decision in Dominion Resources, Inc. v. United States, 83 A.F.T.R. 2d 1350(E.D. VA 1999), the United States District Court for the Eastern District of Virginia stated that the true focus of the required inquiry is whether there is a substantive nexus between the right to the income at the time of receipt and the subsequent circumstances necessitating a refund or restoration. Because of these nexus requirements, the vast majority of cases in which the alternative tax computations under I.R.C. § 1341 were allowed involved the return to the payor (or his successor in interest), of sums originally received from that payor and included in income under a claim of right thereto. See, e.g., Van Cleave v. United States, 718 F. 2d 193 (6th Cir. 1983); Prince v. United States, 610 F. 2d 350 (5th Cir. 1980); Estate of Smith v. Commissioner, 110 T.C. 12 (1998). But see, Killeen v. United States, 1 USTC § 9351 (S.D. Cal. 1963)(an income-splitting case). The receipt of income by [redacted] in earlier years from customers who purchased its products bears no such transactional relationship or nexus with payments it made in later years to contractors for environmental remediation.

Usher v. Commissioner, T.C. Memo 1980-180 provides an example of how close the transactional relationship must be. In that case, the facts involved one parcel of real estate. In 1973 and 1974, the taxpayers received payments totaling $200,000.00

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been taken as costs of goods sold, and thus reduced gross income, in earlier years.

Another flaw is presented by the fact that they remain in litigation with their insurance carrier seeking reimbursement for costs of environmental remediation. Until the matter of their reimbursement is settled, their entitlement to deductions in later years and the amounts of those deductions remain unclear.

from two persons under certain real estate option contracts regarding that parcel. They included the $200,000.00 in income in 1973 and 1974. In 1975, however, the taxpayers were required to pay a third person $200,000.00 in settlement of a breach of contract action involving a separate option contract on the same parcel of real estate. Even though the income and subsequent payment derived from option contracts on the same parcel of land, the Tax Court held that I.R.C. § 1341 was not available because the settlement arose out of a different contract from those that had produced the previously-reported $200,000.00 in gross income.

The contracts under which [redacted] made remediation payments bear even less relationship to the contracts on transactions under which they received income from the sale of various products in earlier years. It is also important to note that the environmental remediation would have been required even if [redacted] had received no income or even if less income than reflected by the costs of remediation had been received from the sale of goods in the early years. And, as noted earlier, the costs of remediation [redacted] has incurred bears no relationship to the amounts of income they previously reported from sales of products.

5. The Amount Of The Deduction Exceeds $3,000.00.

The taxpayers and the examining agents agree that the deductions claimed by [redacted] exceed $3,000.00 in each year.

6. The Provisions Of I.R.C. § 1341(a) Are Not Specifically Made Inapplicable Because The Item Which Was Included In Gross Income Was Included By Reason Of The Sale Or Other Disposition Of Stock In Trade Of The Taxpayer (Or Other Property Of A Kind Which Would Properly Have Been Included In The Inventory Of The Taxpayer If On Hand At The Close Of The Prior Taxable Year) Or Property Held by the taxpayer primarily for sale to customers in the ordinary Course Of His Trade Or Business.

It is also apparent that I.R.C. § 1341(b)(2) precludes this taxpayer, a manufacturer and seller of inventoriable goods, from using I.R.C. § 1341 to determine its tax liability. Section 1341 does not apply to deductions attributable to repayment of items included in gross income in a previous year on account of sale or disposition of inventory. I.R.C. § 1341(b)(2); Treas. Regs. § 1.1341-1(f)(1). The taxpayer is a manufacturer of goods; it maintains inventory of these manufactured good for sale in the

ordinary course of its business.[7]

The arguments that the taxpayer must make to avoid I.R.C. § 1341(b)(2) actually create a non-sequitur with their argument that I.R.C. § 1341 applies at all. In order for the taxpayers to obtain I.R.C. § 1341 relief in the first instance, they must establish that the remediation expenses constitute costs of goods sold in order to fit into the definition of gross income found in Treas. Reg. § 1.61-3.[8] To prevail on this point, the taxpayers must prove that the clean-up costs were, in fact, cost of manufacturing goods from [redacted] through [redacted]. If the taxpayers are successful in this regard, the remediation costs should reasonably be treated as cost of manufacturing, i.e. inventory costs. If that is the case and the costs are inventoriable, I.R.C. § 1341(b)(2) precludes the taxpayer from using § 1341 to compute their income tax liability.

[redacted] looks to legislative history to argue that the preclusion applies only to matters involving sales returns and guarantees. See explanation of legislative history at page 10, supra. In support of their argument, they cite two cases: Killeen v. United States, 1 USTC § 9351 (S.D. Cal. 1963) and Portland Copper & Tank Works, Inc., 43 TC 182 (1964), aff'd., 351 F.2d 460 (1st Cir. 1965). Quite simply, the two cases do not support [redacted] argument.

In Killeen, a manufacturer and a designer entered into a joint venture agreement to produce and market a speed control device. The joint venture agreement provided that the *net profits* would be divided equally between the manufacturer and the designer. Net profits were defined in the joint venture agreement to be gross receipts minus certain enumerated cost of manufacturing. The manufacturer collected all of the receipts and retained all of the net profits in contravention of the

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[7] To the extent [redacted] claims relate to their packaging and construction ventures, we do not have the facts necessary to determine whether I.R.C. § 1341(b)(2) applies.

[8] In In re Lilly, 76 F. 3d 568 (4th Cir. 1966), the Fourth Circuit Court of Appeals' innocent spouse case on which the taxpayers seek to rely to support their argument that a diminution in cost of goods sold is equivalent to the required "inclusion of an item of gross income" for purposes of § 1341, the appellate court noted that "cost of goods sold" is an inventory accounting concept. Id. at 572.

agreement. The designer later obtained a judgment in state court for its portion of the net profits that had been wrongfully withheld. The manufacturer then paid over the required share of profits and claimed § 1341 relief for the deductible payment to the designer. The Service tried to invoke §1341(b)(2) to preclude the taxpayer from availing itself of § 1341 by arguing that the payment to the designer had previously been included in gross income "by reason of the sale or other disposition of stock in trade". The District Court held that the amount paid to the designer in satisfaction of the judgment was *net profits* previously reported by the manufacturer and *not* items included in gross income on account of the sale of inventory.

The taxpayer views the Killeen situation as an exception to the § 1341(b)(2) exception. The only *true* exception to that provision applies to public utilities. In fact, § 1341(b)(2) simply does not come into play in the Killeen scenario. The facts of Killeen show that the issue pertained to the division of net profits under a contractual arrangement, after the taxpayer had reported all of the profits in his gross income. The case did not deal with sales returns and allowances, sales discounts, and the like. Therefore, there was no § 1341(b)(2) issue for the Court to consider. Killeen is clearly distinguishable from the [redacted] situation because there is no income-splitting involved in the [redacted] fact pattern.

A cursory reading of the head notes to or the dicta from Portland Copper & Tank Works, Inc., 43 T.C. 182 (1964), aff'd., 351 F.2d 460 (1st Cir. 1965) might leave a reader believing that it gives some support to the taxpayers' argument. When one realizes, however, that the version of I.R.C. § 1341 applied by the Court contained language that no longer exists and that the facts are distinguishable from those presented by [redacted] one sees that it lends no support whatsoever.

In Portland Copper, the taxpayer was a subcontractor which, in the year before the Court, primarily furnished jet engine components to General Electric which in turn had contracts with the Federal Government. GE contracted with the taxpayer for production of specific items by means of purchase orders stating fixed prices, arrived at by negotiation of the parties. The contracts were subject, however, to price redetermination provisions. Such contracts were used with respect to new items where the Government or a prime contractor was uncertain at the time of the making of the contract as to the production costs of the item and was unable to make a reasonable estimate of such costs. Under these contracts, the parties could renegotiate the

price of the items causing increased payments to be made to the taxpayer or refunds made to GE. In relation to these contracts Portland Copper set up a "Reserve for contract readjustment." In filing its income tax return, it reduced its accounts receivable by the amount of its reserve for contract readjustment. Id.

The issue before the Tax Court was whether it was proper for the taxpayer to reduce its taxable income by the amount of its reserve for refund on its contracts. The Court held that it was not proper because the petitioner's liability for refunds was contingent and not properly accruable. In so holding, the Court noted that the proper method of adjustment for such refunds was found under I.R.C. § 1341 and 1482. Id. This would be a bit startling were it not for the fact that I.R.C. § 1341(b)(2) contained an additional sentence at the time of the taxable years before the Court which is no longer found in the statute. At the time under consideration by the Court, the provision read as follows:

> (2) Subsection (a) does not apply to any deduction allowable with respect to an item which was . . . stock in trade . . . or property held by the taxpayer primarily for sale to customers . . . . **This paragraph shall not apply if the deduction arises out of payments or repayments made pursuant to a price redetermination provision in a subcontract entered into before January 1, 1958. . . .**

I.R.C. § 1341(b)(2)(emphasis added); Id.

Thus, the facts of the case fell within the provisions of I.R.C. § 1341 in place at the time because an exception to the exclusion that was specifically stated in the statute dealt with the precise factual situation before the Court. That exception to the exclusion no longer exists. Even if it did, the facts raised by [redacted] have nothing to do with repayments made pursuant to price redetermination provisions of contracts.

There is simply no support for [redacted] argument that the exclusion in I.R.C. § 1341(a)(2) only applies sometimes.

ISSUE 2

A settlement between [redacted] and the Service that resolves the disputes as to the amount of money spent or incurred for environmental remediation and the year(s) in which such costs

were spent or incurred would not create a litigating hazard for the Government if trial of the I.R.C. § 1341 issue becomes necessary. Because the characterization of the sums paid or accrued as costs of goods sold or as "other deductions" might affect the arguments set forth in such a trial, the characterization of the amounts should not be agreed to until the Service has determined the proper characterization. Since it is our opinion that the Government has a very strong position on the I.R.C. § 1341 issue, characterization for the purposes of settlement is not, however, a great concern.

RECOMMENDATION

We recommend that the taxpayers' claims be denied in full. We believe that the taxpayers' chances of prevailing on this issue if litigated are negligible. Accordingly, we further recommend that you afford no value to the taxpayers' claims for purposes of negotiating the resolution of this issue in isolation or for resolving any issues raised by the taxpayers or the examining agents during the course of the audit.

Please feel free to contact me at (804) 771-2885 with any additional questions you may have. We are forwarding a copy of this advice to the Assistant Regional Counsel (Tax Litigation) (CC:SER) and to the Office of Assistant Chief Counsel (Field Service)(CC:DOM:FS) for mandatory 10 day post review. To assure that the National Office has had sufficient time to review our advice, we request that you refrain from taking any action with respect to the taxpayers' claims prior to July 15, 1999.

Cheryl M.D. Rees

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Attorney

cc: SER Assistant Regional Counsel (TL)
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